26 July 2013

Mr James Cox
Chief Executive Officer
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB POST OFFICE NSW 1230

By email: ipart@ipart.nsw.gov.au

Dear Mr Cox

ActewAGL Distribution (ActewAGL) welcomes the opportunity to provide this submission in response to IPART's Interim Report of the Review of the method for determining the WACC (the interim report).

Though not directly regulated by IPART, ActewAGL owns and operates the electricity distribution network in the Australian Capital Territory (ACT) and gas distribution networks in the ACT, Queanbeyan and Palerang, and Shoalhaven (Nowra).

ActewAGL broadly supports IPART's methodology as outlined in the interim report. The proposed method makes significant progress in addressing the problems identified with the previous methodology, which have arisen since the global financial crisis in 2008.

ActewAGL considers, however, that specific parameter inputs could be improved by addressing the following elements of the interim decision's approach:

- estimates using current market data of the Market Risk Premium (MRP) are falsely precise and would be better represented as a range;
- a 10-year term to maturity for the government bond rate and private cost of debt should be adopted consistently across different industries; and
- the 7-year Bloomberg bond index should be adjusted to appropriately reflect the 10-year term being estimated.

These are discussed further below.

False precision in the estimate of the MRP using current market data

When estimating a range for the Weighted Average Cost of Capital (WACC) using current market data with an averaging period of 40 days, IPART uses a point estimate for the MRP parameter, based on Bloomberg data. When estimating a WACC range using long-term averages, IPART uses a range estimate of 5.5-6.5 per cent.

ActewAGL considers that the interim methodology should adopt a range for the *current market data* estimate, as current estimates of the MRP are typically less certain than those of the long-term average MRP. The interim methodology should be adjusted to reflect this, for example IPART might adopt an equally wide range of ± 0.5 per cent around the Bloomberg value.

Methods of estimating the current MRP are typically based either on variations of the dividend discount model, such as used by Bloomberg or by SFG in its study attached to the interim report, or by relating the MRP to other economic variables, examples of which appear in academic literature. Similar models have been proposed by the Electricity Networks Association for use in electricity network regulation and considered by the Queensland Competition Authority as a forward-looking estimate of the MRP.[1] All of these models include some uncertainty that would likely produce a range of outputs and should be considered by IPART.

Term of the risk free rate and cost of debt

IPART states that the 5-year term to maturity for the government bond rate and private cost of debt is based on the advice of Davis in 2010, sometimes referred to as *the NPV=0 principle*. ActewAGL notes that this advice was to match the term used with the length of the regulatory reset, suggesting, for example, that a term of only four years should be applied in the case of a four-year regulatory period.

However, on page 19 of the interim report, IPART states "we consider that the best approach would be to reflect how an efficient firm in practice would finance its operations in a competitive product market." ActewAGL agrees with this statement and considers that it is not appropriate to match the term of debt to the length of the regulatory period. Instead, IPART should consistently adopt a 10-year term, in accordance with the approach applied to electricity and gas businesses, in order to better match the long life of the regulated assets and the appropriate financing practice for investments in the business.

Further, when estimating the debt margin applied to retail gas and electricity businesses, the interim report uses Bloomberg's 7-year fair value curve in the context of 10-year debt costs. This is a fair estimate of the cost of debt at a 7-year term to maturity, but will typically underestimate the cost at a 10-year term as a 10-year term carries more risk than a 7-year term. ActewAGL considers that the Bloomberg value should be extrapolated to 10 years in order to fairly estimate long-tenor debt costs. Several possible extrapolation methods have been proposed and considered in regulatory decisions of other Australian regulators.[2] [3] [4]

IPART should give consideration to potential extrapolation methods, and adopt an extrapolated Bloomberg value as the relevant input for the cost of debt parameter.

---

[1] Electricity Networks Association, *Response to AER Rate of Return Guideline Consultation Paper*, 28 June 2013. Queensland Competition Authority, *The Risk-free Rate and the Market Risk Premium*, Discussion Paper, November 2012, p10. The Cornell method is listed as a forward-looking method for the MRP.

[2] Essential Services Commission Victoria, *Price Review 2013: Greater Metropolitan Water Businesses – Final Decision*, June 2013. This report uses paired bonds.

[3] Essential Services Commission of South Australia, *SA Water's Water and Sewerage Revenues 2013/14-2015/15 Final Determination Statement of Reasons*, May 2013. This report uses an indicative premium.

[4] Australian Energy Regulator (AER), *Powerlink Transmission determination 2012-13 to 2016-17*, April 2012. AER, *Final Distribution Determination Aurora Energy Pty Ltd 2012-13 to 2016-17*, April 2012. AER, *Access arrangement final decision Envestra Ltd 2013-17 Part 1*, March 2013.

Other issues

IPART states "unless there is strong contrary evidence, we will allocate equal weights to the information obtained from current market data and long-term averages."[5]

In section 6 of the report, IPART lists four sources of evidence that it will consider in making this assessment.[6] ActewAGL considers that IPART should clarify what level of evidence would be considered sufficiently 'strong' to justify a move away from the 'default' midpoint position, particularly where there is a paucity of relevant transactions and expert reports, or where interpreting how the evidence is to be related to the output of IPART's method is difficult.

A further type of evidence which IPART might consider is alternative financial models such as the Fama-French 3-factor model proposed by some other submissions to the earlier Discussion Paper. IPART has listed this model in section 4 of the interim report as information that may be considered,[7] however it is not mentioned in section 6 of the report on 'Further work'. ActewAGL supports giving further consideration to evidence from other models.

IPART also makes the interim decision to conduct an internal consistency test of whether "the regulatory cost of debt is lower than the regulatory cost of equity in our WACC determination".[8] ActewAGL considers that there may be more relevant internal consistency checks that should be considered, for example consistency of parameters and data in each application of the Capital Asset Pricing Model (CAPM). Further investigation by IPART of relevant internal consistency cross-checks would be warranted, such as looking to other equity models and economic and financial market conditions to inform both internal consistency and the appropriate WACC value from the range.

ActewAGL looks forward to further opportunity for consultation on the method as it is developed. Should you wish to discuss in detail any of the matters raised above, please contact Mr Chris Bell, Manager Regulatory Affairs, on (02) 6248 3180.

Yours sincerely

[redacted]

David Graham
Director, Regulatory Affairs and Pricing

---

[5] IPART WACC Methodology Interim Report, June 2013, p9
[6] Ibid, p31
[7] Ibid, p23
[8] Ibid, p10